Impact of IFRS on the Maritime, Shipping and Transport Industries

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Presentation agenda

- Introduction
- Impact of Key IFRS to the industry
- Q&A

Introduction

- Maritime, Shipping and Transport Industries that apply IFRS are affected by all applicable IFRSs
- The industry is capital intensive, hence impact of IAS 16 is major.
- Players more often operate in multiple jurisdictions, IAS 21 considerations are key
- Revenue recognition is affected by multiple contracts in the shipping sector. IAS 18 considerations are important.
- The industry has significant leasing arrangements – IAS 17 is key to the industry.

Property, plant and equipment

- Some of the most critical estimates and judgments in accounting for the vessels constitute decisions on:
    i. the costs that should be capitalised
    ii. depreciation method
    iii. Estimates of useful life
    iv. impairment

Property, plant and equipment

- Vessels are the most significant item of property, plant and equipment.
- Vessels and other related infrastructure are expensive items to build and are constructed with the expectation of having long remaining useful lives.
- IAS 16 requires that costs that can be capitalised be those that are directly attributable to bringing the vessel to the location and condition necessary for it to be capable of operating in the manner intended by management.

PPE- Costs to capitalise

This will include:

- Total consideration paid to the.
- Capitalised borrowing costs.
- Equipment installed on the vessel.
- Vessel registration and certifications.
- Seaworthiness certificates.
- Legal and professional fees attributable for acquisition.
- Amounts paid for options to purchase the vessel.
- Supervision costs during the construction period.

PPE- Costs to capitalise

Challenges in assessing costs to capitalise involve the following judgement areas:

- ❖ Treatment of pre-delivery instalments
- ❖ borrowing costs capitalisation
- ❖ Capitalisation consideration for repairs and maintenance.

PPE- Costs to capitalise

Pre-delivery instalments (PDIs)

- PDIs are used to secure the purchaser's place in the delivery timetable for the vessel. They are part of the standard contractual terms at most shipyards, often agreed years in advance of the actual construction of the vessel.
- PDIs should be treated as prepayments and be capitalised to the vessel once risk and rewards (control) passed to the purchaser.
- PDIs could also be recorded within PPE if the amount is material and shown separately under a heading such as "Vessels under construction".

PPE- Costs to capitalise

Borrowing costs (IAS 23)

- Vessels under construction generally meet the definition of a qualifying asset under IAS 23.
- Borrowings incurred to finance the purchase of ready-to-sail secondhand vessels will not usually qualify for capitalisation.
- Capitalisation of borrowing costs should be suspended during a period when no construction is taking place and should cease when substantially all vessel construction activities are complete.

PPE- Costs to capitalise

Repairs and maintenance

- These costs should be capitalised only if they meet the recognition criteria in IAS 16; otherwise they are expensed.
- costs that merely maintain the economic benefits initially envisaged are expensed, while those that provide additional future economic benefits either in the form of an increase in future productive capacity or an extension of economic life are capitalised.

PPE- Costs to capitalise

Dry-docking costs and component accounting

- A vessel requires seaworthiness checks, under water inspections, intermediate surveys and special surveys.
- Each of these checks may be eligible for separate capitalisation under the IAS 16.
- Costs relating to checks mostly pertain to dry docking and special surveys, which constitute a major component of vessel costs.
- Components such as hull, engine, superstructure, navigation system, dry docking and special surveys have different useful lives hence component accounting applies.

PPE- impairment

Vessels are tested for impairment if indicators of impairment exist, e.g:

- over-capacity, vessels operating at suboptimal levels;
- low economic growth, reduce demand for ocean transportation;
- new market entrants, which may contribute over-capacity;
- increased competition from alternative transportation methods;
- falling freight rates leading to operating losses;
- falling new-build or second-hand vessel prices;
- increased vessel recycling rates in the industry;
- physical damage to vessels, e.g. due to accidents; and
- technological obsolescence- introduction of more efficient vessel models or changes in regulation;

Leases- IAS 17

Leases feature abundantly in the shipping industry even though the term “lease” is less often used in shipping contracts. Vessel owners engage in charter contracts to earn income, while charterers often view these charter contracts as a financing alternative to bank loans and other types of borrowings.

Examples of contractual arrangements that are leases:

- lease of vessels;
- bareboat charter contracts;
- tax lease contracts;
- slot charter (NVOCCs); and
- time charter contracts.

Leases- IAS 17

The assessment of whether to classify a vessel lease arrangement as an operating or finance lease is important as it leads to significantly different financial impact.

Some key indicators of a finance lease:

- ✓ Lease transfers ownership of the asset to the lessee;
- ✓ Lessee has the option to purchase the asset at below market;
- ✓ Lease term is for the major part of the asset's economic life;
- ✓ Present value of the minimum lease payments is close to the fair value of the leased asset when the lease contract is signed;
- ✓ Lessor's losses associated with the cancellation of a lease are borne by the lessee;
- ✓ Lessee can extend the lease term at a below-market rent and the extended lease term covers the major part of the asset's economic life.

IAS 17 Finance leases

- Under a finance lease, the vessel owner derecognizes the vessel, and recognizes a receivable for the charter payments yet to be received.
- The charter recognizes the vessel and a payable for any charter payments yet to be paid.
- The vessel is recognised as PPE by the charterer when the vessel becomes available for use, i.e. the beginning of the lease term.
- The lessee recognises the vessel at its fair value or, if lower, the present value of the minimum lease payments

IAS 17 Operating leases

- Both parties treat the contract as an executory contract with charter payments being recognised in income or expense on a straight line basis over the charter period.
- The effect of unconditional charter escalation clauses – for example, charter rate increases by 5% each year – must be straight-lined.
- Rights and obligations, other than accrued or prepaid charter payments, are not recognised for operating leases.
- Operating leases are off - balance sheet arrangements for the lease under IAS 17.
- Dry docking, inspection and survey costs incurred by the leasee for vessels that are chartered from a lessor under an operating lease are capitalised if they meet capitalisation criteria.

IAS 18 Revenue

- Revenue is critical to many shipping companies.
- The varied types of shipping transactions (e.g. time and voyage charters, freight services, slot exchange arrangements)
- Shipping transactions also have a wide range of clauses (e.g. demurrage, bunker adjustment, choice of alternative ports) creating challenges for revenue recognition in terms of amount and timing of revenue recognised.
- Shipping contracts can also become onerous and require a liability to be recognised on the balance sheet.

IAS 18 Revenue

- Charter income is treated as operating leases with revenue recognised over the periods of the lease on a straight-line basis.
- Voyage income arises from a voyage charter, which involves the hiring of a vessel and crew for a voyage between a load port and a discharge port.
- IAS 18 require that revenue and costs should be recognised respectively based on stage of completion when the outcome of transaction can be estimated reliably.
- Most shipping companies adopt a cost-based or time-based method for estimating stage of completion.

IAS 18 Revenue

Liquidated damages

- Liquidated damages are amounts that another party must pay for non-performance e.g. failure of shippers to meet minimum volume commitments and to deliver cargo on time.
- Demurrage is a shipping term that refers to liquidated damages for delays that arises when a vessel fails to load or unload cargo within the agreed period of time.
- Shipping container usage beyond the time allowed is referred as Container Demurrage.
- Demurrage income is only recognised as revenue when it can be estimated reliably, and it is probable that it will be received.

IAS 18 Revenue

Agent vs Principal

- An agent recognises only his fee as revenue, and the amounts collected on behalf of the principal are not revenue.
- In contrast, a principal recognises the entire contract sum as revenue.
- A freight forwarder that receives monies from a customer to arrange for a suite of inter-modal transportation services needs to assess whether he is merely an agent helping the customer to arrange for other transportation services.

IAS 18 Revenue

Slot exchange

- Shipping companies seek to exchange the surplus capacity ("slots") on their vessels with the surplus capacity of other shipping companies. This helps to fully utilise the vessel and minimise the costs arising from empty slots for both parties
- Revenue will not be recognised as a result of slot exchange arrangement for other slots. However, when the swapped slots are subsequently sold off to shipping customers, revenue will be recognised. This also avoids double counting of revenue.

IAS 18 Revenue – Onerous contracts

- Revenue contracts can become onerous over time if they cannot be cancelled without paying a significant penalty or other compensation to the counterparty.
- IAS 37 requires a provision for the minimum unavoidable costs of meeting obligations under onerous contract.

Examples of contracts that may become onerous are:

- ✓ operating lease contracts for vessels when there is overcapacity;
- ✓ contracts to buy or sell non-financial items at a fixed price;
- ✓ bareboat charters in / out; and
- ✓ fixed rental arrangements of slots by non-vessel operating common carriers (“NVOCCs”) i.e. ocean freight forwarder.

IAS 21 Functional currency

- Shipping entities operate in an international environment and are exposed to a variety of currencies.
- Functional currency is the currency of the primary economic environment in which the entity operates and expends cash.
- Presentation currency is the currency in which the financial statements are presented, and can take the form of any currency.
- A shipping entity does not have a free choice of its functional currency under IFRSs. It considers primary and secondary factors giving more weight to primary factors.

IAS 21 Functional currency

Primary Indicators

- ✓ What is the currency that mainly influences the shipping prices?
- ✓ What is the currency that mainly influences labour, material and other costs of providing shipping services?
- ✓ What is the currency of the country whose competitive forces and regulations mainly determine the shipping prices?

Secondary Indicators

- ✓ What is the currency in which funds from the financing activities are generated?
- ✓ What is the currency in which receipts from operating activities are usually retained?

IAS 21 Functional currency

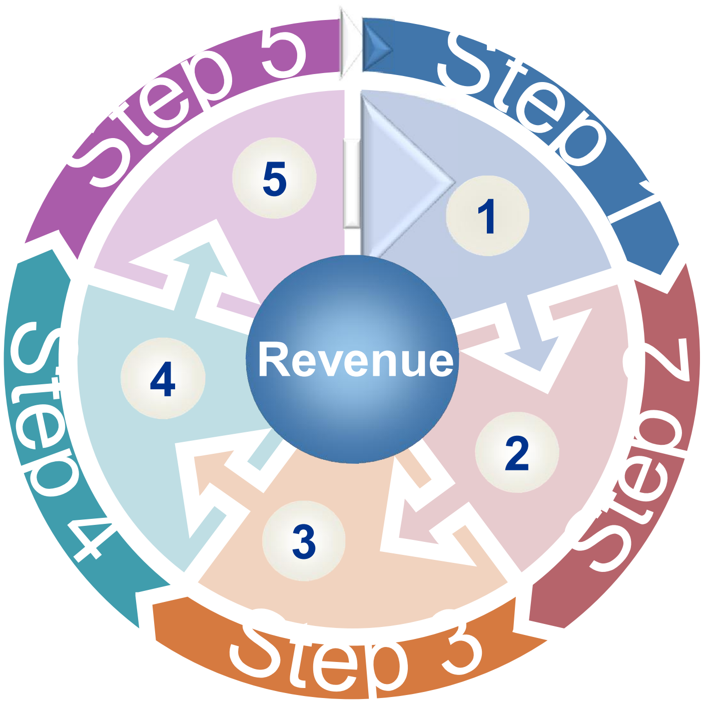
Most shipping companies have the USD as the functional currency for a number of reasons:

- ✓ Firstly, most if not all global freight rates are influenced by the USD.
- ✓ Secondly, a large proportion of cost in the shipping industry arises from bunker fuel, which has a global market in USD.

Impact of New IFRSs

- IFRS 15
- IFRS 9
- IFRS 16

IFRS 15 introduces a 5 Step Model – Overview



1. Identify the contract with a customer
2. Identify the performance obligations
3. Determine the transaction price
4. Allocate the transaction price to performance obligations
5. Recognise revenue as Performance Obligations Satisfied and control is transferred to buyer

IFRS 9 – New impairment model (from incurred to expected)

Expected loss model

=

Past events

+

Current conditions

+

Forecast of future economic conditions

WHAT'S NEW?

IFRS 16 Lease

- Applies to lessees and lessors
- All leases will be on balance sheet
- A key judgement area for lessees

	Lease classification test	On B/S	Off B/S
New standard	✗	**Lease**	**Service Contract**
Old standard	✓	Finance Lease	Operating Lease

IFRS 16 Lease Definition

ICPAK
Uphold Public Interest

A contract that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration.

Definition focuses on control over the use of an identified asset.

Assessed at inception

Identified asset

- Asset may be explicitly or implicitly specified in a contract;
- Asset is physically distinct – applies to distinct portions but not generic capacity; and
- Lessor does not have a substantive right to substitute another asset.

Right to direct use

- Customer has the right to (**throughout the period of use**):
  - Obtain substantially all of the economic benefits from use of the asset; and
  - Direct (including the right to *change*) how and for what purpose the asset is used.

Interactive Session